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Comments of the Zentraler Kreditausschuss[1] on the BIS consultation papers 'Revisions to the Basel II market risk framework' (CP 148) and 'Guidelines for computing capital for incremental risk in the trading book (CP 149)'

1. April 2009

[1] The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (VdP), for Pfandbrief banks. Collectively, they represent more than 1,900 banks.

We thank you for the opportunity to comment on the two consultation papers entitled 'Revisions to the Basel II market risk framework' (CP 148) und 'Guidelines for computing capital for incremental risk in the trading book (CP 149)'.

Before we comment on the changes in both papers in detail, we would like to make a few basic preliminary remarks.

A. General comments

Against the background of financial turmoil we can in principle understand the efforts of the supervisory authorities to increase capital adequacy requirements in order to cover market risks and additional risks in the trading book. However, in future the capital adequacy requirements should also match the risks estimated by the institutions. The banking industry has already undertaken extensive efforts in large parts of internal risk management to deal appropriately with the causes and effects of the financial market crisis. We are of the opinion that adjustments tailored to the situation of an institution offer significant advantages over a blanket increase in capital requirements ordered by a supervisory authority.

Furthermore, coordination between the models used internally by the banks and the supervisory requirements (use test) must be ensured. Particularly in the area of measurement of incremental risks, for which no market standards have existed up to now, the (ongoing) development of models must not be restricted by rigid supervisory regulations. Institutions implement risk models primarily because these are more flexible and more appropriately adapted to their individual risk situation and portfolio composition. With rigid regulatory model specifications which are designed in a predominantly conservative manner, the advantage of an internal model is vitiated. The incentive for risk management based on an institution-specific model is thus significantly reduced. In this context, we continue to doubt whether it is possible to meet the use test requirements on the basis of the specifications of the third consultation paper.

Impact studies of the banking industry show that the proposed supervisory specifications for modelling incremental risks as well as the implementation of stressed-VaR result in an enormous increase in the capital requirements for the trading book regardless of the portfolio. This multiplication of the capital requirements has side effects. In our opinion, the capital-based incentive for the transition from the standardised approach for market risk to the internal models-based approach vanishes due to the increasing capital requirements for the latter method. This

represents a negative incentive for the further internal development and supervisory use of risk models.

In addition, incentives may be created not to assign and manage risk items in the trading book any longer, but to allocate them as far as possible to the banking book. The understandable desire of the supervisory authorities to avoid arbitrage opportunities in favour of the trading book has resulted in the creation of arbitrage opportunities in favour of the banking book. This becomes especially clear in the example of securitised loans: our understanding of para 38 is that the capital requirements for securitised loans in the trading book must always be determined on the basis of banking book regulations. However, because such items must additionally be taken into account in the standard VaR for general market risks (mandatory) and if necessary in the standard VaR for specific risk (optional) as well as in the stressed VaR (mandatory) for calculation of capital requirements, apparently intended arbitrage incentives are created in favour of the banking book.

A lack of incentives for trading book activities affect not only the institution itself. This lack of incentive can lead to a smaller number of market participants with the result that in less liquid markets higher margins can be established and thus the prices for many financial services rise. The market distortions lead to arbitrage opportunities that can have a negative impact on the market prices.

We welcome the extension of the implementation deadline compared to the second consultation paper. However, we also wish to point out to the Basel Committee the differences in content and deadlines between the Basel specifications on the one hand and the currently applicable European and national specifications for handling incremental risks on the other hand. The institutions must not suffer any disadvantages from the uncertainty over the manner in which national supervisory authorities deal with these discrepancies. At the same time the extension of the implementation deadline should also be used to wrap up the discussions still to be carried out without time pressure and with due care. Overly hasty decisions must be urgently prevented in view of the extensive internal model adaptations.

B. 'Revisions to the Basel II market risk framework' (CP 148)

Section II: Entry into force

The Basel Committee should avoid premature decisions in view of the considerable quantitative effects of the proposals. After completion of the planned impact study in spring of this year, a new consultation with the banking industry should take place before the paper is finalised, taking into account the results of the study.

We welcome the extension of the implementation deadline to 31 December 2010.

Section III: Standardised Approach for market risk

The definition of the term 're-securitisation' as well as the increased risk weighting for re-securitisations correspond to those of the banking book. In particular, the definition of the re-securitisations in their current form is rejected by the banking industry in the context of the consultation for the consultation paper entitled 'Proposed enhancements to the Basel II framework'. We request that these comments be noted likewise for the regulations of the trading book.

In our opinion, the proposed capital requirements for re-securitised items should be consistent in the relevant re-securitisation tables (pages 4 and 5). In this respect we request the adaptation of the capital requirements for users of the standardised approach in the two best credit grades. AAA to AA- (A-1/P-1): 2.4 % instead of 3.2 % and A+ to A- (A-2/T-2): 5.2 % instead of 8 %.

We welcome the introduction of fall-back approaches for handling externally unrated securitised loans. With regard to the K_{IRB} (para 712(V) a) to be determined using the supervisory formular approach, it must be noted that with the required compliance with all minimum requirements for the application of the IRBA (valuation of each individual receivable in a securitised portfolio or of the entire portfolio with IRBA-certified rating procedures) the practical applicability of this fall-back approach is limited. We therefore suggest establishing a more flexible approach for the determination of PD and LGD.

We do not feel that the increase to 8 % in the capital requirement for specific price risks of equity positions is appropriate. The capital requirements for the specific risk should continue to be based on the diversification of the portfolio. The financial crisis showed that while the volatilities increased for nearly all financial instruments, the risk in a diversified portfolio is still significantly

lower than in an undiversified portfolio. We therefore recommend that para. 718 (xxi) remain unchanged.

Section IV: Internal model Approach

Quantitative standards

In our view, the quantitative standards described far exceed the goal and will send the wrong management signals and impair the quality of internal risk management and supervisory requirements as well. The specifications for the determination of the stressed VaR will play a considerable role in the future in the determination of capital requirements and will be significantly above the capital requirements of the standard VaR for structural reasons. This will result in a decline in the importance of the standard VaR approach for capital management purposes.

Furthermore, in our view the consultation paper very rightly reinforces the importance of stress tests for internal management and monitoring by the supervisory authorities. However, we view the selection of relevant stress tests critically. Both the stress test procedure itself and the determination of the stressed VaR are based solely on specific historical scenarios.

Many years of observation of historical data have shown that even the ‘financial market crisis’ scenario in 2007/2008 was not very meaningful. Apart from the fact that both years were characterised by a very turbulent capital market, much higher volatilities in fixed-income instruments as well as stocks were recorded in earlier years. Thus the highest interest volatilities in recent times were found in summer 2003. This makes clear that any period, no matter how carefully selected, is only of limited informative use. At the same time, the question of 'the' scenario will remain unanswered. Thus it must be possible to use a variety of scenarios to ensure appropriate stress testing that is suitable for internal management. In this process, all risk factors with their specific stress impact on a portfolio as well as the stress potential from encompassing crisis situations must be taken into account. The recommendations of the Basel Committee in the consultation paper 'Principles for sound stress testing practices and supervision' (CP 147) are also based on this; all relevant risk factors with their specific stress impact as well as the stress potential from encompassing situations should be recorded. Among other things, the complexity of any stress test programme is a reason why stress tests are so poorly suited as indicators for capital requirements.

Thus, in our opinion the actual purpose of stress tests should be kept in mind, namely for internal management and disclosure to third parties and the supervisory authorities. However, stress tests are not suitable for the determination of a regulatory capital charge.

The statement that 'for most portfolios, the Committee would consider a 12-month period relating to significant losses in 2007/2008 to be a period of stress' (page 12) restricts the discretionary margin of the institutions too much, in our opinion. We assume that an institution can select an individual 12-month market data set even without stating detailed reasons. Should such individuality not be possible and the market data set refer only to the 2007/2008 crisis scenario, we request that this be deleted.

If the determination of the stressed VaR is retained, we wish to point out the following: the design of the stressed VaR means that it is not possible for a situation rated as a ‘normal situation’ and another situation rated as a ‘stressed market situation’ to exist simultaneously. It would thus be considerably more plausible and would lead to more realistic capital requirements to link ‘stressed VaR’ and ‘standard VaR’ by means of maximum threshold instead of adding both together.

According to the specifications for determining the stressed VaR, only the qualitative add-on factor x and not the backtesting add-on factor y is to be taken into account for the multiplier. The justification for the factor 3(+x+y) in the conventional market risk VaR as a factor for any existing model errors or model shortcomings cannot be applied to the concept of the stressed VaR. If one views the stressed VaR as a further add-on for model shortcomings, the factor 3 appears unmotivated at the model level as a further conservative appraisal for the VaR already determined under stress. In our view the multiplier should not be used in the stressed VaR.

The stressed VaR is calculated on the methodological basis of the standard VaR. To us, this quantitative specification does not appear to be consistent with the Basel Committee's standard for stress tests: ‘Stress testing should provide a complementary and independent risk perspective to other risk management tools ... Stress tests should complement risk management approaches.’ (page 14 in Consultation Paper No. 147 'Principles for sound stress testing practices and supervision').

Quantitative Standards – Other remarks

We welcome the fact that, in contrast to initial considerations of the Basel Committee, the possibility of scaling a 1-day VaR to a 10-day VaR using the 'root t' formula will be retained. The elimination of this option would have led to further considerable charges for the institutions.

Another point to be emphasised is the permission to use weighted time series as long as the calculated risk is higher than that in an unweighted case (footnote 11, page 11). The use of the maximum thus provides room for incorrect management signals. The result is unsuited for internal management and should therefore not be used for the capital requirments of internal models.

Stress testing

In the choice of scenarios, specific historical scenarios are emphasised. In our opinion, these are not necessarily well suited to model future stress situations. Rather, future-oriented scenarios should be designed on the basis of historical experience in order to survive in new market constellations. To this extent, the choice of scenarios should be much broader than only the mere replication of historical events.

Treatment of specific risk

For the institutions, according to the specifications of IR modelling, it is possible to calculate no IR charge for equity risks; IR modelling can be eliminated. We welcome the option of undertaking the modelling of equity event risks as part of the specific market risk VaR. In this context it is unclear which requirements should be demanded of the standard 10-day VaR models. The proof that event risks (e.g. in merger trading strategies) are sufficiently reflected in these models may be frequently difficult to provide. The requirements posed here must not be so extensive that the modelling cannot be approved and the calculation of capital requirements according to the market risk standardised approach is required.

Our understanding of the Basel specifications for specific interest rate risks is that here as well, event risks are also to be taken into account in the standard 10-day VaR models. Such event risks are primarily market risks arising from migration events; they must be taken into account within IR modelling according to the specifications of the third consultation paper. In order to preclude to

double counting, we consider it appropriate not to demand event risk modelling within the standard 10-day VaR framework.

Model validation standards

It is already possible for a situation to occur in which outliers can be identified based on a particular market constellation for which the standard 10-day VaR is not modelled. In this case the outlier would not be counted. This applies particularly if the outliers arise due to the manifestation of incremental risks. Thus, for example, rating events are recorded in IR modelling, but can still lead to backtesting outliers and a presumably poorer forecast quality of the standard VaR model caused by these. The previously existing leeway of the supervisory authorities in the question of whether outliers are counted or not must be remained in the future. We request clarification.

We welcome the new specification which German institutions have already followed for many years that requires evaluating the model quality of the VaR models exclusively on the basis of a clean backtesting approach. Only the comparison of the VaR estimate and the clean P&L, but not the comparison of the VaR estimate and the dirty P&L, permits an appropriate evaluation of the model quality. Because even international institutions which were previously allowed by supervisory authorities to carry out only dirty backtesting must in the future present clean P&L results, it appears to us to be inconsistent not to use these results for counting the backtesting exceptions as well. Dirty backtesting on the basis of the dirty P&L will generally show a smaller number of outliers than corresponding clean backtesting due to the generally positive contributions to the result contained in the dirty P&L which do not result from an risk taking. As the number of exceptions determines the backtesting add-on factor, the use of the dirty P&L results tends to lead to lower capital requirements with significant negative effects on the international competitive situation. Under Pillar III the number of these exceptions must be disclosed; the results thus on the public perception of the bank. The unpreventable mixing of outlier numbers on the basis of clean backtesting with the numbers from dirty backtesting in a comparison of institutions is a significant disadvantage for the institutions using clean backtesting and cannot be justified. Thus, for reasons of competition we urge that only clean backtesting results be taken into account, including for the counting of the backtesting exceptions.

Section V: Pillar II

The future capital requirements will be extremely conservative according to initial impact studies carried out by the industry. This is due to the already conservative specifications for each individual summands, but also to the fact that based on the additive approach, diversification effects such as those between the risks recorded in the standard VaR and the risks subject to an IR charge are not taken into account. Due to this situation, it appears to be of little use particularly for the trading book items and unnecessary to apply additional add-ons under Pillar II at all.

Section VII: Handling of illiquid items

With the specifications for handling illiquid items, the Basel Committee touches on the international accounting standards. Thus, in our view there are overlaps between the consultation paper and, on the other hand, existing accounting requirements in IAS 39 and the guidance published by the IASB Expert Advisory Panel in October 2008 entitled 'Measuring and disclosing the fair value of financial instruments in markets that are no longer active'. The International Accounting Standards Board (IASB) is generally responsible for the uniform application and interpretation of the IFRS framework, while the International Financial Reporting Interpretations Committee (IFRIC) is responsible for the interpretations of the standards. We request that Section VII be written so that neither an expansion of the requirements of international accounting practice for German banks nor restrictions for the entities preparing the financial statements ensue.

The new requirement *'It should maximise the use of relevant observable inputs and minimise the use of unobservable inputs when estimating fair value using a valuation technique. However, observable inputs or transactions may not be relevant, such as in a forced liquidation or distressed sale, or transactions may not be observable, such as when markets are inactive. In such cases, the observable data should be considered, but may not be determinative'* (page 22) is worded identically to Principle 5 of the Basel consultation paper entitled 'Supervisory guidance for assessing banks’ financial instrument fair value practices' (CP 145), which discusses aspects of valuation methods. We request that this be deleted in the interests of the aforementioned delineation.

C. 'Guidelines for computing capital for incremental risk in the trading book' (CP 149)

Principles for the calculation of IRC

IRC-covered position and risks

The deficiencies of risk measurement regarding banks using internal models in the financial market crisis made it clear that an approach based exclusively on ratings is not capable of estimating the special risk factors of securitisations adequately. Thus it is astonishing that the Basel Committee now wishes to rely completely on external ratings in the calculation of capital requirements. Particularly for banks using advanced models, this cannot be the right path. In view of the negative experience with external credit ratings of the external rating agencies during the financial crisis, we question why the Basel Committee does not rely more on the requirements of internal risk measurement methodologies.

We therefore consider the removal of all securitisation items from the determination of the IR capital requirements to be too undifferentiated and wrong. Even if, as explained in para 10, securitisation items can be regarded as hedge instruments, they may not be taken into account in the determination of the IR capital requirements. This artificially tears hedge connections apart. We request the option of determining the capital requirements for such items on the basis of the internal model. If as there are reservations concerning the extent to which a hedge remains stable in a stressed market situation, this challenge can be solved by a reasonable definition of the 'hedge relationship'.

Even if there is no hedge relationship, we consider it excessive not to permit such securitisation items in the determination of the IR capital requirements based on the internal model. Depending on the complexity of the relevant securitisation structure, sophisticated institutions may be capable of internally modelling many of these instruments adequately. This will apply even more so in the future if the efforts of the institutions are taken into account in the improvement of the risk measurement for such instruments. These efforts should be promoted and not inhibited by the supervisory authorities. The extent to which appropriate models for securitisation positions exist can be checked by the supervisory authorities at any time. Institutions should therefore have the option of using their own product- or portfolio-specific models upon proof of suitability.

Finally, we request clarification that any necessary removal of certain transactions for the calculation of the IRC is not necessarily a removal of these items from the internal model-based risk determination. This would diametrically oppose the character of the VaR as a portfolio

approach and increase the discrepancy between the IRC model and internal model-based risk measurement.

Constant level of risk over one-year capital horizon

We continue to view the use of the banking book specifications by Basel II as a reference point and as a justification for the regulatory selection of a 'one year capital horizon and 99.9 % confidence level' as incomprehensible and incompatible with the conditions of a trading environment. For economic risk management, banks use risk management strategies that are not compatible with the assumption of a 'constant level of risk over a one-year capital horizon' and thus should be taken into account in the calculation of the capital requirements. This would make the IRC considerably more appropriate with regard to risks and provide incentives for the further development of risk management as well. To this extent we welcome the new provision in para 31. However, this option does not go far enough yet, as only 'dynamic hedging strategies' are discussed here, which however constitute only a part of the conceivable risk management strategies.

Liquidity horizon

In Items 18 and 24, the determination of appropriate liquidity horizons is discussed in the context of securitisations. From this we conclude that the Basel Committee is also considering, as we requested above, continuing to include securitisations in the determination of IR positions.

The floor of a three-month horizon appears considerably too high in view of the fact that the IRC is based on trading book items. This is especially true because the Committee primarily bases its assumptions on a stress situation (' … liquidity in many parts of the securitisation markets dried up …', page 4). Rather, the institutions themselves should be responsible for determining appropriate liquidity horizons for the relevant items. The establishment of a floor of three months prevents taking the various market situations into account appropriately.

Should the supervisory authorities not be able to decide to give the responsibility for determining liquidity horizons to the institutions, we urge that a still conservative floor of only one month be used, as there are numerous positions for which a floor of three months would be too long, e.g. for positions that have a shorter residual term. Three months will also be too long for most loan products as well as for single-name and index CDS.

We continue to assume that it is possible to assume a uniform liquidity horizon (' … appropriate liquidity horizon for a position or set of positions …', page 4) if as the floor conditions have been met. We request corresponding clarification.

Correlations and diversification

The Committee demands that interactions between the default and migration risks be taken into account in IR modelling. As the diversification effect between these risks and other risks in the trading book has not been sufficiently well understand yet, this effect should not play any role in IR modelling yet. We believe this approach is justified on the grounds for ensuring the overall consistency of the Basel II framework in which diversification between market and credit risks is not permitted either. In our opinion, the model banks should not be prevented from using the option of taking diversifications between the aforementioned risks into account in the model.

Concentration

With regard to concentration in the IR model, the Committee explicitly insists on taking concentration into account in stress situations. We request an explanation of how these stress situations can be taken into account in the model.

Validation

There are ambiguities regarding how validation of IR models can be undertaken for a one-year period at a confidence level of 99.9 %. Validation using the conventional market risk backtesting approach is not feasible. To this extent we welcome the corresponding clarification reference in the fourth bullet point. However, we doubt that the stress tests mentioned there are suitable backtesting instruments.

It should be primarily at the discretion of the institutions to carry out appropriate validation. Only after market standards for the modelling of incremental risks have been developed can detailed regulatory requirements be established for validation. At the present time the development of procedures that cannot contribute to validation of the model should not be pursued.

Frequency of validation

The Basel Committee plans a weekly calculation of the incremental risk charge.

The parameters underlying the model, particularly to assumed minimum holding period of up to one year, constitute an unreasonably long period for trading products. This is in contrast to the very short calculation cycle of the IRC. In our opinion, a one-week period is too short to integrate in the previous processes without difficulty. For one thing, the technical calculation cycles often require more than one night. For another, the data for the weekly calculation and the results calculated on this basis must undergo quality control and be integrated in the internal risk management process. In order to represent such a process on a weekly basis, personnel must be added and the technical systems further developed. This requires additional financial resources that again reduce the incentive for internal modelling. We therefore suggest aligning the IRC calculation with the other reporting cycles and recommend a monthly calculation. Should the supervisory authorities not be able to consent to this, at least the option should be granted to omit,on a weekly adjustment, non-essential parameters and extremely labour-intensive parameters. A purely quantitative determination of the regulatory figures would still be ensured.

Alternative Approach

We reject the alternative approach, according to which the capital requirements for all items in the trading book that contain specific risks (e.g. only for illiquid items) are to be determined according to the rules of the banking book. The application of the banking book regulations for such items would be a considerable step backwards in the already long- and well-established risk management for specific interest rate and equity risks. In addition, such an approach is also problematic due to the lack of risk sensitivity of the measuring procedure, as on the one hand market risks such as spread movements are not adequately reflected, and on the other concentration risks are not adequately taken into account.

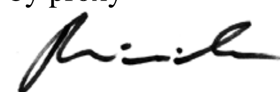
Yours sincerely,

on behalf of the

Zentraler Kreditausschuss,

Bundesverband der Deutschen
Volksbanken und Raiffeisenbanken e.V.

by proxy



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